

REPORT OF EXAMINATION  
OF THE

PREFERRED EMPLOYERS  
INSURANCE COMPANY

AS OF  
DECEMBER 31, 2006

Filed December 4, 2007

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Los Angeles, California  
October 5, 2007

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

**PREFERRED EMPLOYERS INSURANCE COMPANY**

(hereinafter also referred to as the Company) at the primary location of its books and records, 1455 Frazee Road, Suite 1000, San Diego, California 92108.

**SCOPE OF EXAMINATION**

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records; and sales and advertising.

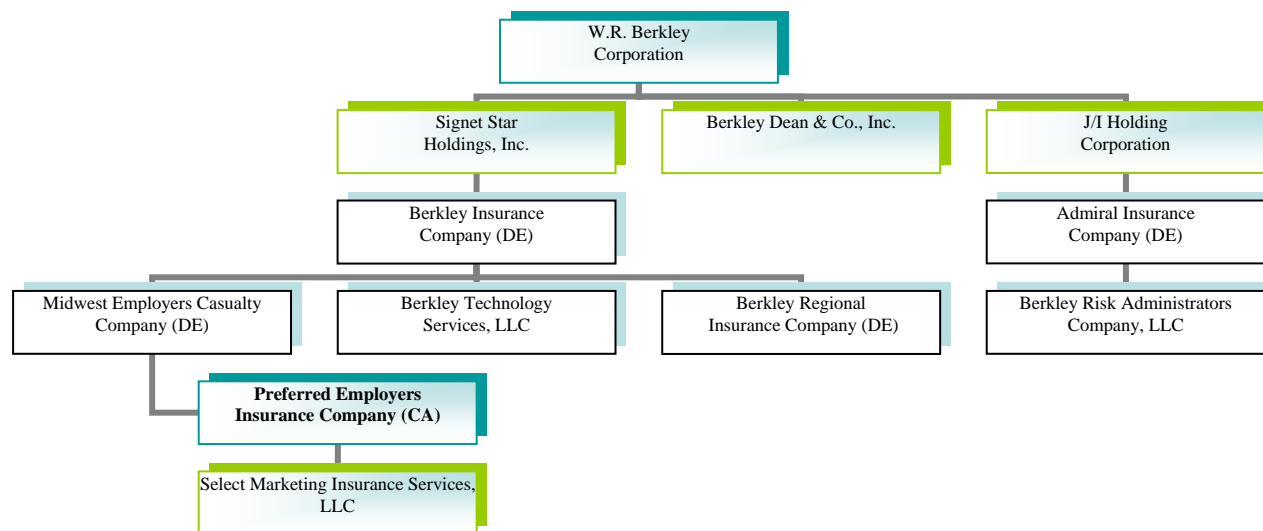
## COMPANY HISTORY

The Company was incorporated in California on December 11, 1997, and commenced business on June 1, 1998. The Company writes workers' compensation coverage in California and focuses on the particular needs of small employers specializing in businesses with less than 50 employees. The Company is a member of the W.R. Berkley Corporation insurance group.

The Company has 10,000 common shares authorized and 3,500 common shares issued and outstanding. Par value per share of common stock is \$1,000.

## MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Midwest Employers Casualty Company and is part of an insurance holding company system of which W.R. Berkley Corporation is the ultimate controlling entity. The following abridged organizational chart depicts the Company's relative position within the holding company system: (all ownership is 100%)



Management of the Company is vested in a three-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

#### Directors

##### Name and Residence

##### Principal Business Affiliation

Robert D. Stone  
Greenwich, Connecticut

Senior Vice President  
W.R. Berkley Corporation

Ira S. Lederman  
Greenwich, Connecticut

Senior Vice President  
W.R. Berkley Corporation

Linda R. Smith  
San Diego, California

President and Chief Executive Officer  
Preferred Employers Insurance Company

#### Principal Officers

##### Name

##### Title

Linda R. Smith  
Miklos F. Kallo  
Jan A. Beaver  
Thomas H. Boggs  
Marc Beaulieu \*  
John C. Bennett  
Rosemary Favier  
Randy Sysol

President and Chief Executive Officer  
Senior VP, Chief Financial Officer and Treasurer  
Vice President and Secretary  
Vice President, Underwriting  
Vice President, Marketing  
Vice President  
Vice President, Claims  
Vice President, Information Technology

(\*) Resigned effective April 27, 2007 and not replaced.

## Management Agreements

Administrative Service Agreement: Effective February 1, 2006, the Company entered into an Administrative Service Agreement with its subsidiary, Select Marketing Insurance Services, LLC (SMI). Under the terms of the agreement, SMI is engaged in the operation of marketing and soliciting workers' compensation insurance business for the Company. The Company, in turn, provides SMI human resources, accounting functions, computer resources and office facilities. SMI reimburses the Company for the actual cost of services and facilities it provides. SMI is compensated by the Company based on the actual cost of the aforementioned services. The California Department of Insurance (CDI) approved this agreement on December 27, 2005. For 2006, the costs of services provided by SMI to the Company are equal to the actual cost of the services provided by the Company to SMI, resulting in no payments to either party.

Computer Services Agreement: Effective January 1, 2002, the Company entered into a Computer Services Agreement with its affiliate, Berkley Technology Services, LLC (BTS). Under the terms of the agreement, BTS provides the Company with certain computer and data processing services, including programming, network management, operations and consulting services. BTS is compensated by the Company for the actual cost of these services. The CDI approved this agreement on February 15, 2002. For 2004, 2005, and 2006, the Company paid BTS \$279,292, \$593,541 and \$621,129, respectively, in fees under the terms of this agreement.

Underwriting Services Agreement: Effective September 6, 2002, the Company entered into an Underwriting Services Agreement with its affiliate, Berkley Risk Administrators Company, LLC (BRAC). BRAC is the legal representative of an affiliated insurance company, Berkley Regional Insurance Company (BRIC), which writes workers' compensation and employers' liability in the State of Nevada. Under the terms of the agreement, BRAC, with BRIC's authorization, delegates to the Company certain functions pertaining to the BRIC business including, but not limited to, the following: rating; underwriting; policy issuance functions; and the handling and servicing of all claims and losses. The Company is compensated by BRAC for its services based on actual cost. The fees charged by the Company can not be greater than what BRIC would have expended had it provided such services for itself. The CDI approved this agreement on September 5, 2002. For

2004 and 2005, the Company received \$10,662 and \$1,292, respectively, in fees from BRAC under the terms of this agreement. No fee was collected in 2006 since the Company no longer provides BRAC with these services.

Investment Advisory Agreement: Effective April 23, 1998, the Company entered into an Investment Advisory Agreement with an affiliate, Berkley Dean & Co., Inc. (BDC). In accordance with the Company's investment guidelines, BDC provides investment advisory and management services. BDC is compensated based on an annual fee equal to .25 of 1% of the first ten million dollars and .20 of 1%, thereafter of the net asset value of the portfolio at the end of each quarter. The CDI approved this agreement on April 27, 1998. For 2004, 2005 and 2006, the Company paid BDC \$98,882, \$131,850 and \$128,590, respectively, in fees under the terms of this agreement.

Tax Allocation Agreement: The Company is a party to a Tax Allocation Agreement with its affiliates and its ultimate parent, W.R. Berkley Corporation (WRB). Under the terms of this agreement, the companies file a consolidated federal income tax return. The consolidated federal income tax liability is allocated between the companies in the ratio that each company's separate tax return liability bears to the total consolidated federal tax liability. This agreement was entered into and approved by the CDI on April 27, 1998. For 2004, 2005 and 2006 the Company paid \$2.2 million, \$2.7 million and \$4.0 million, respectively, in income tax to WRB under the terms of this agreement.

### TERRITORY AND PLAN OF OPERATION

As of December 31, 2006, the Company was licensed to transact workers' compensation insurance in the State of California. The Company only writes workers' compensation business and currently does not plan to write any other lines. In 2006, the Company wrote \$135 million in direct premiums.

Business is marketed and produced through a network of approximately 70 independent agents located throughout California. The Company's statutory home office in San Diego, California also

serves as a sales office and a claims processing facility. On September 13, 2004, the Company opened a claims adjusting office in Walnut Creek, California.

## REINSURANCE

### Assumed

The Company had no assumed reinsurance.

### Ceded

The largest net amount retained by the Company is \$500,000 on any one risk for casualty lines. The following is a summary of the principal reinsurance agreements in-force as of December 31, 2006:

Type of Contract	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
Quota Share			
Quota Share	Berkley Insurance Company	10% of net liabilities	90% of net liabilities
Excess of Loss			
First Excess of Loss	Various/Authorized and Unauthorized	\$5 million	\$5 million excess of \$5 million
Second Excess of Loss	Various/Authorized and Unauthorized	\$10 million	\$15 million excess of \$10 million

The total reinsurance recoverables due the Company as of December 31, 2006, under the terms of its reinsurance agreements, was \$218.4 million or 924.2% of surplus as regards policyholders. Of the total reinsurance recoverables, \$217.7 million or 99.7% were recoverables from the Company's



affiliate, Berkley Insurance Company, under the terms of the 90% quota-share reinsurance agreement.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2003 through December 31, 2006

Statement of Financial Condition  
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 63,687,331	\$	\$ 63,687,331	(1)
Cash, cash equivalents and short-term investments	819,705		819,705	
Other invested assets	2,000		2,000	
Investment income due and accrued	886,147		886,147	
Uncollected premiums and agents' balances in the course of collection	3,567,004	396,739	3,170,265	
Reinsurance: Amounts recoverable from reinsurers	8,157,377		8,157,377	
Current federal and foreign income tax recoverable and interest thereon	229,045		229,045	
Net deferred tax asset	2,047,918	1,308,330	739,588	
Guaranty funds receivable or on deposit	21,601,893	47,556	21,554,337	(2)
Electronic data processing equipment and software	291,235	291,235		
Furniture and equipment, including health care delivery assets	732,148	732,148		
Aggregate write-ins for other than invested assets	<u>57,318</u>	<u>25,089</u>	<u>32,229</u>	
Total assets	<u>\$ 102,079,121</u>	<u>\$ 2,801,097</u>	<u>\$ 99,278,024</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 17,496,448	(3)
Loss adjustment expenses			6,130,400	(3)
Commissions payable, contingent commissions and other similar charges			908,020	
Other expenses			2,666,837	
Taxes, licenses and fees			15,845,089	(2)
Unearned premiums			1,607,554	
Ceded reinsurance premiums payable			17,479,783	
Amounts withheld or retained by company for account of others			2,842	
Payable to parent, subsidiaries and affiliates			196,690	
Aggregate write-ins for liabilities			<u>13,314,705</u>	(4)
Total liabilities			75,648,368	
Common capital stock		\$ 3,500,000		
Gross paid-in and contributed surplus		7,500,000		
Unassigned funds (surplus)		<u>12,629,656</u>		
Surplus as regards policyholders			<u>23,629,656</u>	
Total liabilities, surplus and other funds			<u>\$ 99,278,024</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 14,105,959
Deductions:		
Losses incurred	\$ (280,785)	
Loss expense incurred	1,872,656	
Other underwriting expenses incurred	<u>2,231,524</u>	
Total underwriting deductions		<u>3,823,395</u>
Net underwriting gain		10,282,564

Investment Income

Net investment income earned	\$ 2,564,849	
Net realized capital gain	<u>63,668</u>	
Net investment gain		<u>2,628,517</u>

Other Income

Net loss from agents' or premium balances charged off	\$ <u>(518,024)</u>	
Total other income		<u>(518,024)</u>
Net income before federal income taxes		12,393,057
Federal income taxes incurred		<u>3,285,158</u>
Net income		<u>\$ 9,107,899</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 19,394,666
Net income	\$ 9,107,899	
Change in net deferred income tax	(229,909)	
Change in nonadmitted assets	286,475	
Aggregate write-ins for gains and losses in surplus	<u>(4,929,475)</u>	
Change in surplus as regards policyholders		<u>4,234,990</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 23,629,656</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			\$ 14,289,920
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 18,552,144	\$	
Change in net deferred income tax	693,531		
Change in nonadmitted assets		832,349	
Aggregate write-ins for loss in surplus	<u>                    </u>	<u>9,073,590</u>	
Total gains and losses in surplus	<u>\$ 19,245,675</u>	<u>\$ 9,905,939</u>	
Net increase in surplus as regards policyholders			<u>9,339,736</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$ 23,629,656</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds

A review of the above captioned account disclosed that the Company maintains most of its bonds through the custody of Chase Manhattan Bank Trust Company, N.A. (CMB). Effective December 1, 2001, CMB merged with and changed its name to J.P. Morgan Trust Company, N.A. (JP Morgan). As a result of the merger and by operation of law, JP Morgan succeeded to all of the rights and obligations of CMB, including custodial services provided by CMB to the Company. As a qualified custodian in California, JP Morgan appointed JP Morgan Chase Bank (JPMC) to serve as its agent (sub-custodian) in performing certain duties and responsibilities under the custody agreement, which includes confirmation and certifications of account balances. On September 28, 2007, the Company filed an amended custodial agreement with the California Department of Insurance (CDI) reflecting the name change of its custodian.

### (2) Guaranty Funds Receivable or on Deposit

#### (2) Taxes, Licenses and Fees

Starting in 2000, the California Insurance Guaranty Association (CIGA) began assessing the Company for its share of policyholder obligations relating to several insolvencies of companies writing workers' compensation business in California. As of December 31, 2006, the Company estimated a remaining liability of \$16.1 million (net of \$20.3 million previously paid in 2006) associated with these assessments and reported it under the above captioned Taxes, Licenses and Fees liability account.

The Company recoups the guaranty fund assessments through a 2% surcharge on its policyholders' premiums. The Company reported a \$21.6 million asset for the 2% surcharge in the above captioned receivable account, which includes a \$5.3 million advance payment to CIGA in 2006.

The above captioned asset and liability accounts were established in accordance with Statements of Statutory Accounting Principles (SSAP) No. 35.

### (3) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the CDI, the Company's loss and loss adjustment expense reserves as of December 31, 2006 were found to be reasonably stated and have been accepted for purposes of this examination.

Losses incurred have decreased from the prior period by approximately \$4.9 million. The decrease was a result of the lower claims cost and the impact of reduction in pure premium level that shows the cost savings associated with the enacted reforms to the California workers' compensation system.

Legislative reforms to the California workers' compensation system were passed in 2003 and 2004 to curb the growing cost and encourage new carriers to enter the California marketplace. Key elements of the reforms include medical provider networks, utilization review, apportionment and a new schedule for permanent-disability rating.

### (4) Aggregate Write-ins for Liabilities

In addition to \$4.2 million of earned but unbilled premium, the above captioned liability account includes excess of statutory reserves over statement reserves of \$9.1 million as required by California Insurance Code (CIC) Section 11558. CIC Section 11558 states, in part, that the minimum reserve required for the workers' compensation line of business must be 65% of earned premiums (loss ratio) for each of the last three accident years. As of year-end 2006, the Company reported 39%, 43.9% and 62.2% loss ratios for the 2004, 2005 and 2006 accident years, respectively, for this line of business. The \$9.1 million liability established by the Company represents the difference between the loss ratio reported by the Company as of year end 2006 and the 65% minimum loss ratios required by CIC Section 11558.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

None.

### Prior Report of Examination

Management and Control - Conflict of Interest (Page 5): It was recommended that the Company implement procedures to annually obtain and review completed conflict of interest statements from all of its officers, directors and key employees. The Company complied with this recommendation.

Corporate Records (Page 5): It was recommended that the Company implement procedures to ensure future compliance with California Insurance Code Section 735. The Company complied with this recommendation.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 13): It was recommended that the Company continue to review and monitor its historical data maintained on its claim system and implement corrective actions should the Company find material discrepancies. The Company complied with this recommendation.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and its employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Ferdinand Ison  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California